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IN THE

Supreme Court of the United States

October Term, 1951

E. Field White, *Petitioner*,

v.

John J. Fitzpatrick, as Collector of Internal Revenue for the District of Connecticut, *Respondent*.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT AND BRIEF IN SUPPORT THEREOF.

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To the Honorable Chief Justice and Associate Justices of the Supreme Court of the United States:

The Petitioner, E. Field White, prays that a writ of certiorari be issued to review the decision of the United States Court of Appeals for the Second Circuit in the above case.

OPINIONS BELOW.

The Memorandum Decision of the District Court (R. 23a) is unreported. The opinion of the United States Court

of Appeals for the Second Circuit (R. 103) is reported in F. (2d) .

JURISDICTION.

The judgment of the Court of Appeals was entered on December 10, 1951, (R. 113). The jurisdiction of this Court is invoked under 28 U. S. C. Section 1254(1), 62 Stat. 928.

QUESTIONS PRESENTED.

Taxpayer transferred by gift to his wife "the entire right, title and interest in and to" a patent which he owned and used in his business of manufacturing chokes for use on the barrels of shotguns. The wife then granted an exclusive license of the patent to the taxpayer in consideration for the payment of royalties to her, which royalties were found by the District Court, to be reasonable in amount.

Taxpayer's wife also purchased and acquired absolute title to real property which she leased to taxpayer for use in his business for rent which the District Court found to be reasonable in amount. The following day taxpayer made a gift to his wife of the approximate purchase price of the property. The questions presented are:

1. Whether the amounts paid by taxpayer as royalties on the use of the patent were deductible under Section 23(a)(1)(A) of the Internal Revenue Code as ordinary and necessary expenses of doing business.

2. Whether the amounts paid by taxpayer as rental on the use of the business property were deductible under Section 23(a)(1)(A) of the Internal Revenue Code as ordinary and necessary expenses of doing business.

3. Whether the court below erred in holding that these expenses were not deductible because of "the way" in which they became necessary.

STATUTE INVOLVED.

The statute involved is Section 23(a)(1)(A) of the Internal Revenue Code.

> "Sec. 23. Deductions From Gross Income. In computing net income there shall be allowed as deductions:
>
> (a) Expenses.—
>
> (1) Trade or Business Expenses.—
>
> (A) In General.—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, * * * and rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity."

STATEMENT OF FACTS.

The facts may be summarized as follows:

During the years in question the taxpayer was engaged in the business, in Tariffville, Connecticut, of manufacturing a device known as a "poly choke", for use on the barrel of a shotgun. He was the sole proprietor and carried on the business under the name of the Poly Choke Company. He had developed this invention about 1932, and by 1937 was producing it commercially (R. 83a). On December 27, 1932, taxpayer obtained a United States patent on the "poly choke" (R. 84a).

On January 21, 1941, taxpayer transferred to his wife, Madge B. White, the entire right, title and interest in and to the patent by assignment, the terms of which are set forth in the District Court's Findings of Fact (R. 84a-85a).

On the following day, January 22, 1941, Madge B. White licensed the taxpayer, doing business as the Poly Choke Company, to make, have made, and to sell the patented devices, with the right to grant sub-licenses. The license agreement called for the payment of specified royalties per

unit produced and was cancellable, among other things, upon the taxpayer's failure to continue production. The terms of this instrument are set forth in the District Court's Findings of Fact (R. 85a-87a).

The patent assignment was recorded in the United States Patent Office in 1946 (R. 87a). Taxpayer filed a Federal gift tax return for the year 1941 in which he reported a gift of the patent to his wife (R. 87a).

Taxpayer paid his wife royalty payments of $22,390 in 1941, $14,183 in 1942, $10,000 in 1943, and $13,094 in 1944 (R. 88a), which she reported as income in those years (R. 89a).

From November 1, 1939 to December 27, 1940 taxpayer occupied the premises upon which his business was conducted under a lease granting a non-transferable option to purchase the property for $15,370 (R. 88a).

On December 27, 1940, when the lease had ten months to run, taxpayer's wife paid $16,800 to the owner for the purchase of the property (R. 88a). On the following day taxpayer made a gift of $16,175 to his wife (R. 88a). Taxpayer filed a gift tax return reporting such gift (R. 74a).

Thereafter, and through the year 1943, taxpayer paid his wife $1,536 per annum as rent for the use and occupancy of the property. There was no written lease. In each of those years taxpayer was allowed that amount as a deduction in computing his taxable net income. During the first eleven months of 1944, taxpayer paid his wife a total of $1,408 as rent. In December of that year, following a discussion of cost of repairs to the roof of one of the buildings, taxpayer paid his wife $5,000 as an adjustment of rent (R. 89a). Taxpayer's wife reported these amounts in her individual income tax returns (R. 89a).

The taxpayer's wife had had extensive experience in and always managed her own personal business affairs (R. 48a, 49a, 54a, 78a, 79a, 81a).

By a ninety-day letter dated June 29, 1948, the Commissioner of Internal Revenue disallowed the deductions

claimed as royalty payments in the years 1941, 1942, 1943 and 1944, and disallowed $4,872 claimed as part of the rental payment for the year 1944 (R. 90a).

On or about August 3, 1948, taxpayer paid the Collector of Internal Revenue the deficiencies asserted by the ninety-day letter, and on or about October 11, 1948, he paid the Collector interest of $4,977.05 on the asserted deficiency for the year 1941, $3,725.17 for the year 1943, and $3,955.63 for the year 1944 (R. 90a-91a).

Taxpayer filed timely claims for refund on January 10, 1949, for those portions of the asserted deficiencies attributable to the disallowance of the amounts claimed as payments of royalties and of rent to his wife. On July 18, 1949, taxpayer filed timely amended claims for refund of the sums of interest paid to the Collector (R. 91a).

The District Court also found as follows:

> "The amounts paid were reasonable in amount as royalty payments under the license agreement." (R. 88a).
>
> "The amounts paid by the plaintiff to his wife during the years mentioned as rent were reasonable rentals for the property for those periods." (R. 89a).
>
> "In making the assignment of the patent to his wife and in giving her the money to make good the purchase price of the property on which he held an option, the taxpayer was motivated by a desire to make good the losses his wife had suffered in her inherited estate and to minimize the income taxes upon his family group." (R. 91a).
>
> "The relations between the taxpayer and his wife were most friendly and it was the taxpayer's expectation that no action would be taken by the wife in the exercise of her rights of ownership of the patent or real property which would be detrimental to the plaintiff's interests." (R. 91a-92a).

SPECIFICATION OF ERRORS TO BE URGED.

The Court of Appeals for the Second Circuit Erred:

1. In holding that the amounts paid to the taxpayer's wife, as patent royalties, were not deductible as ordinary

and necessary business expenses under Section 23(a)(1)(A) of the Internal Revenue Code.

2. In holding that the amounts paid to the taxpayer's wife, as rentals, were not deductible as ordinary and necessary business expenses under Section 23(a)(1)(A) of the Internal Revenue Code.

3. In departing from the statutory criteria of deductibility specified in Section 23(a)(1)(A) of the Internal Revenue Code.

4. In affirming the decision of the District Court.

REASONS FOR GRANTING THE WRIT.

The stark naked question here presented is simply this: Can a taxpayer who has made a complete and irrevocable gift of income-producing property (or money with which in part to pay for such property) to or for the benefit of his wife, and who thereafter pays her precisely the same reasonable rentals and royalties for the business use thereof on exactly the same terms and conditions as he would pay to a stranger, deduct such rentals and royalties under section 23(a)(1) of the Internal Revenue Code? The Seventh and Third Circuit Courts of Appeals have held that he can. In the instant case, the Second Circuit Court of Appeals, by a divided court, holds to the contrary.

I.

Section 23(a)(1)(A) allows a taxpayer to deduct "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business * * * including * * * rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, * * * ".

The Court of Appeals disapproved as deductions the royalty and rental payments made by the taxpayer by erroneously applying criteria established for the construc-

tion of an entirely different taxing statute, to wit, section 22(a) of the Internal Revenue Code. *Helvering* v. *Clifford*, 309 U. S. 331 (1940). Even as it did so, the majority in the Court of Appeals conceded, that in the context of Section 23(a)(1)(A) "the question is a rather new one". The theory upon which the Court proceeded is that although the wife admittedly acquired absolute title to the patent and to the business real estate involved, it was not "necessary" that the taxpayer thereafter pay her royalties and rent for the use of her properties in his business.

This same theory was advanced by the respondent in *Skemp* v. *Commissioner*, 168 F. (2d) 598 (C.A. 7, 1948), and rejected by the Court of Appeals for the Seventh Circuit. In that case a taxpayer transferred property to a trust for the benefit of his wife and children specifically reserving to himself the right to rent all or a part of the property at a rental to be determined by the trustee. Writing for a unanimous court, Judge Minton observed, "While the taxpayer voluntarily created the situation which required the payments of rent, the fact remains that the situation created did require the payments". That Court also observed that the "issue before us is the narrow one of *deduction* and does *not* involve the taxability of the trust income under *Helvering* v. *Clifford*." (Italics supplied)

The Court of Appeals for the Third Circuit concurred with the principles set forth in the *Skemp* case and reversed the Tax Court in *Brown* v. *Commissioner*, 180 F. (2d) 926 (C.A. 3, 1950), and this Court denied the respondent's petition for certiorari, 340 U. S. 814 (1951). The *Brown* opinion pointed out that the rents and royalties were there reasonable, that the taxpayers were legally obligated to pay such rents and royalties, and concluded that the case turned upon principles which were "identical" with those announced in the *Skemp* case.

In both the *Skemp* and *Brown* cases the taxpayers transferred properties which they owned, and which they were at the time using in their respective businesses, to trusts established for the benefit of their immediate families.

In the instant case the Court below held that those transfers " * * * being to trustees, were sufficiently outright, to be distinguishable from our present case". But as remarked by Judge Chase in his dissenting opinion, this "is a distinction without a difference since that bore only on the completeness of the gifts and reasonableness of the royalties and rentals paid, both here shown and found."

Judge Chase further stated:

> "Perhaps it would be desirable to protect the revenue by amending Section 23(a)(1)(A) to exclude from the business expense deductions now allowed those which become necessary only because of intra-family gifts of property used, or to be used, in the business. But that is a matter to be determined by Congress and, until it acts, I think courts are bound to give effect tax-wise to gifts which are fully effective otherwise.
>
> " . . . The findings, based on evidence adequately supporting them, show that everything was done to transfer the legal and equitable titles both to the patent and the building absolutely to the wife, and the ownership she thereby acquired gave her the right to whatever she could get by way of royalties and rents which were, of course, taxable to her as income."

II.

The instant decision, by a divided court, is not only in conflict with those of the Seventh and Third Circuit Courts of Appeals on the same point, but strikingly illustrates the sharp split of opinion presently existing within the Second Circuit itself.

The record is abundantly clear that both the royalties and the rents were reasonable in amount, as was expressly found by the trial court. Judge Chase insisted that the reasonable royalties and rents were well within the scope of the applicable statute, were required by the license and lease arrangements, and therefore were deductible.

In so concluding, Judge Chase applied the principle set forth in *Wodehouse* v. *Commissioner*, 177 F. (2d) 881 (C.A. 2, 1949), where Swan, C. J., writing for the majority,

pointed out that the donor had relinquished absolutely all interest or control over the property transferred, and stated: "A husband may be so certain that his wife will follow his advice in business matters that he will assume to act on her behalf without previous consultation, but this does not mean that he has reserved legal power to do so when making her the gift." In *Johnson* v. *Commissioner*, 86 F. (2d) 710, 712, (C.A. 2, 1936) Judge Swan, speaking for the court, had previously said: "The distinction, though often hard to detect in fact, is perfectly clear in principle between creating rights which you trust will not be exercised and creating no legal rights at all; a transaction of the first kind changes existing legal relations between the parties, the other does not."[1]

This view has likewise found clear acceptance in other Courts of Appeals. In *Henson* v. *Commissioner*, 174 F. (2d) 846 (C.A. 5, 1949) where the taxpayer irrevocably divested himself of all legal right, title and interest in the business, and was thereafter retained by his wife as manager thereof, the Court of Appeals for the Fifth Circuit said:

> "Every owner of a business, particularly those of limited business experience, has the undoubted right to have it managed by another, even though that person be married to the owner. Moreover, every husband has a legal right to create a valid gift of his property in favor of his wife without being held liable for the income tax thereon, provided, of course, there are no conditions attached which would enable him to retain a legal dominion and control over the property, or to revoke the transfer. No such conditions are

[1] In *Molnar* v. *Commissioner*, 156 F. (2d) 924 (C.A. 2, 1946), Judge Learned Hand, concurring, pointed out at page 927:

> "However, I think that only in the rarest instances should we overrule so recent a decision of our own court, however much in a court differently constituted the judges may disagree with it; for it is as much the function of the Supreme Court to decide differences within a circuit as between circuits."

found to exist here. In this case, the wife was no partner, but became the undisputed and absolute owner of the business, under and by virtue of the gift from her husband. Under such circumstances, the income therefrom was taxable to her alone, and not to the petitioner." (Citing cases) See also *Alexander* v. *Commissioner*, 190 F. (2d) 753 (C.A. 5, 1951).

In the instant case, the wife had received absolute title to the patent by a complete and irrevocable assignment. When she granted to her husband a license to manufacture under it, she retained, and her agreement established, a complete basis of enforcing her right to receive the royalty payments to her because of use of the patent, for failure to receive which she could take appropriate action at law. As the absolute owner of the real estate used as business premises, she granted only a month to month tenancy (Section 7106, Gen. Stats. Conn., Rev. 1949), and for failure to pay the rents properly to be due to her she was entitled to and exercised the complete protection afforded to a landlord under the law of the State of Connecticut.

III.

Section 23(a)(1)(A) provides that an expense must be a "business" expense, and that it must be both "ordinary" and "necessary", and this Court has asserted that in construing this section the only problem is "to ascertain what provisions Congress has made regarding such expenditures as those for which the petitioner claims the right of deduction." *McDonald* v. *Commissioner*, 323 U. S. 57 (1944).

Certainly the payment of royalties under a patent license is an ordinary and usual expense to the manufacturer of a patented product. So, too, is the payment of rent for premises used in the production of that product.

The majority below did not question that the deductions claimed meet these requirements of the statute nor did it challenge the reasonableness of the payments. It reasoned,

in effect, that these expenses were not "necessary" because of "the way"[2] in which they became necessary.

Even if the *Clifford* yardstick can be stretched to apply in respect of a question of deductibility under section 23 (a)(1)(A), and two Circuit Courts of Appeal have held that it can not, nevertheless, the court below incorrectly interpreted this Court's opinion in that case and is in conflict therewith. The findings of the District Court do not support a conclusion that the taxpayer retained a substantial measure of control over the patent which he had transferred to his wife, or over the real estate to which she had acquired absolute title from a third party. The taxpayer's wife admittedly owned and, even after the license and lease, could sell, give away, *inter vivos* or on death, or otherwise dispose of her patent and her real estate as she saw fit. As pointed out by Judge Chase, "whatever control the taxpayer received was the control of a licensee and lessee and was conditioned upon making the payments here claimed to be deductible. It would seem erroneous, therefore, to deny the claimed deduction on this basis."

This Court's decision in *Commissioner* v. *Sunnen*, 333 U. S. 591 (1948), was relied upon by the trial court, and was cited below, in determining the measure of purported control retained by the taxpayer. It should first be noted that the *Sunnen* case did not involve the question of deductible business expense. But, equally significant, the *Sunnen* case must be distinguished in that the taxpayer, Sunnen, never relinquished but continued at all times to own the patent itself, assigning to his wife merely a "non-exclusive" license contract as to which he retained the right of cancellation at any time. It was under those circumstances that this Court held that Sunnen had merely transferred a right to receive future income, and even that right remained wholly within his control.

The frailty of the trial court's conclusion, accepted by the majority below, is emphasized by its finding (R. 91a)

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[2] (From the dissenting opinion of Judge Chase)

that "it was the taxpayer's *expectation* that no action would be taken by the wife in the exercise of her rights of ownership of the patent or real property which would be detrimental to the plaintiff's (taxpayer's) interests." (Italics supplied) Yet the Second Circuit Court of Appeals itself had declined to find control under similar circumstances in the *Johnson* case (86 F. (2d) 710 and *supra*).

The court below reasoned that the "test" established by this Court in the family-partnership field was applicable in determining whether this taxpayer was entitled to the business expense deductions claimed. *Commissioner* v. *Culbertson*, 337 U. S. 733 (1949); *Commissioner* v. *Tower*, 327 U. S. 280 (1946). Judge Clark wrote: "Since here we find no evidence of a potential exercise of 'control and management' on the part of the donee, only of 'passive acquiescence to the will of the donor' . . . payments to the wife do not constitute valid business deductions within the statute." Application of such criteria is entirely erroneous in construing Section 23(a)(1)(A), since deductibility of a business expense certainly does not depend upon a creditor's participation in the business for which the expense was incurred.

Indeed, the above "test" which the Court of Appeals borrowed from the field of family partnerships, has now been abandoned even in that field. Congress has decreed that where there is a real transfer of ownership interest in a family partnership, by virtue of either a *gift* or a sale, and regardless of the motivation and of whether the business is benefited by the entrance of the new partner, the donee or purchaser is liable for the tax on the income. Section 3797(a)(2), of the Internal Revenue Code, as amended by Section 340(a) of the Revenue Act of 1951.[3]

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[3] Indeed, the Senate Finance Committee Report No. 781, 82nd Congress, 1st Session, to accompany H. R. 4473, said, page 38 *et seq.*:

> "Section 339 of your committee's bill is intended to harmonize the rules governing interests in the so-called family partnership with those generally applicable to other forms of

IV.

The instant decision of the Court of Appeals has created a judicial exception to the applicability of Section 23(a)(1)(A) in the case of otherwise deductible expenses incurred by a taxpayer for the use of property which has been the subject of his gift to a member of his immediate family.

This question does not involve the identity of the proper taxpayer as does the *Clifford* line of cases and the family partnership cases. It involves merely the determination

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property or business. Two principles governing attribution of income have long been accepted as basic: (1) income from property is attributable to the owner of the property; (2) income from personal services is attributable to the person rendering the services. There is no reason for applying different principles to partnership income. If an individual makes a bona fide gift of real estate, or of a share of corporate stock, the rent or dividend income is taxable to the donee. Your committee's amendment makes it clear that, however the owner of a partnership interest may have acquired such interest, the income is taxable to the owner, if he is the real owner. If the ownership is real, it does not matter what motivated the transfer to him or whether the business benefited from the entrance of the new partner.

* * *

"However, the frequency with which the Tax Court, since the *Culbertson* decision, has held invalid family partnerships based upon donations of capital, would seem to indicate that, although the opinions often refer to 'intention,' 'business purpose,' 'reality,' and 'control,' they have in practical effect reached results which suggest that an intra-family gift of a partnership interest, where the donee performs no substantial services, will not usually be the basis of a valid partnership for tax purposes. We are informed that the settlement of many cases in the field is being held up by the reliance of the field offices of the Bureau of Internal Revenue upon some such theory. Whether or not the opinion of the Supreme Court in *Commissioner* v. *Tower* (327 U. S. 280) and the opinion of the Supreme Court in *Commissioner* v. *Culbertson* (337 U. S. 733), which attempted to explain the *Tower* decision, afford any justification for the confusion is not material—the confusion exists."

See also House Report No. 586, p. 32, to accompany H. R. 4473.

of taxable business income which Congress has provided shall be net income after deduction of business expenses which are "ordinary" and "necessary."

The Court of Appeals recognized that the assignment of the patent "was legally adequate to transfer all rights adhering thereto to the wife. Likewise the land was purchased in the name of the wife alone." Then, even though such properties were "necessary" in the taxpayer's business, the Second Circuit lays down the rule that it was unnecessary that the taxpayer incur ordinary obligations for the use of such properties in his business only because such obligations ran to his wife. Here is a clear instance of the Court substituting its judgment for that of the taxpayer in the ordinary conduct of the taxpayer's business affairs. *Commissioner* v. *Culbertson, supra.* If this test be accepted, it is reasonable further to conclude that this particular taxpayer would be precluded from deducting royalty payments as business expenses, had he sold the patent and licensed its use; and further that he would have been obliged to purchase this real estate, the business premises, if he chose to use it in his business.

Under the doctrine of the decision below, it is difficult to see how intra-family gifts of income-producing property can ever stand on any different footing than gifts of income only. Certainly a finding that the taxpayer enjoyed amicable marital relations has no place in the determination of the legal issue involved. If any such test is to be adopted in determining the enjoyment and satisfaction which a husband may receive in making a gift to his wife, it can only be inferred that amicable marital relationships do not pay tax-wise.

And it is to be noted in this connection that the decision of the Court of Appeals results in taxing the gross income rather than the net income of this taxpayer, a result which is wholly contrary to congressional intention.

It is respectfully submitted that the case is not simply one of error on the part of the court below. The square

conflict between the Second Circuit and other circuits, the conflict within the Second Circuit itself, the misapplication of the principles enunciated by this Court, the legislative history as to congressional intent, and the questions of public policy involved[4] all lead inevitably to the clear recognition that recurring problems of unforeseen varieties will surely arise unless there be clarification of the pertinent law. The conflicts generated by the majority below and the importance of the problem to a sound administration of the revenue laws clearly merit consideration by the Court.

CONCLUSION.

For the foregoing reasons it is respectfully submitted that the writ prayed should be granted.

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March, 1952.

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[4] For comment from tax services on this aspect see "The Tax Barometer," December 22, 1951, No. 48; Research Institute—Taxation Report, December 19, 1951; Rabkin & Johnson's "Taxes Today" (Matthew Bender & Co., Inc.) Release No. 114, January 1952.